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THE CANADA-U.S. FREE TRADE AGREEMENT AND THE GREAT FREE TRADE DEBATE

by

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On October 3, 1987, Canadian and U.S. negotiators signed the preliminary transcript of a Canada-U.S. Free Trade Agreement. While the outline of the Agreement is clear, clarification of many of the important details -- and, therefore, final judgment of the Agreement -- must await the full, legal text. For understandable reasons, however, participants in the Great Free Trade Debate have chosen not to wait for the final text to be released.

To make a constructive contribution to this debate, my colleagues and I at the C.D. Howe Institute also must judge the Agreement on the basis of the preliminary text. We stress that our judgment is subject to revision in the light of further knowledge about the final text -- but so, we hope, is everyone else's. The final text will be published shortly, but it will take weeks, or even months, to assess it fully. In the meantime, our assessment of the debate about the Agreement covers points that will be relevant for months, or even years, to come.

In this Trade Monitor, we first present our preliminary judgment of the Agreement. We then focus on the debate as it has unfolded since the preliminary Agreement was published. In the Institute's opinion, this debate has rushed on heedless of the lack of any knowledge of the final Agreement's details, and now shows signs of losing touch with reality.

The Institute's Position

We confess that, like many others who had come to hope for what had previously been thought to be unattainable, we were disappointed on first reading the preliminary Agreement. Now that unreasonable expectations have been dashed, we must look at the realistic expectations that the Institute itself expressed more than two years ago.[1] At that time, we

argued for incremental gains in the containment of U.S. trade laws. On that basis, the Agreement is a significant achievement, and Canada did well to get it. As anyone who is versed in collective bargaining knows, getting half of what one asks for is a real gain.

There are three ways to judge this Agreement: as a classic free trade area, as a response to the current problem of nontariff barriers to trade, and as a means of resolving trade disputes.

The Agreement as a Classic Free Trade Area

A classic free trade area deals with trade in goods, and usually excludes certain sensitive sectors. On this criterion, the Agreement appears to be an excellent one. When all the debate about its other aspects is stripped away, the Agreement's most important achievement is to end, over a ten-year period, virtually all tariffs between the two countries, thus taking a significant step toward enhancing Canada's access to its most important foreign market.[2] This is a considerable improvement over the status quo.

The Agreement covers more than is usual in other free trade agreements. For example, all agricultural tariffs are to be removed over a ten-year period, which is a remarkable achievement. All services are covered by the general clause that (i) exempts all existing laws that breach national treatment and (ii) precludes new laws that breach national treatment. Further progress (and possibly some backsliding) is to be covered in specific protocols dealing with specific service industries.

At the same time, some of the Agreement's exclusions are typical of free trade areas, while others are not. One usual exclusion is supply-managed agriculture, which is excluded according to accepted rules of the General Agreement on Tariffs and Trade (GATT). Another usual tactic is to treat textiles and clothing as special cases receiving all sorts of special treatments -- although the specific provisions in the Agreement that do not grant duty-free access to apparel produced from third-country fabrics is unusual, and seems mainly designed to satisfy U.S., rather than Canadian, interests.

Among the exclusions that are unusual for a classic free trade agreement are cultural industries -- quite broadly defined -- and beer.

As a free trade area, the Agreement is a remarkable achievement. It covers in one swoop more than the European Free Trade Area (EFTA), the most successful free trade area to date, has been able to achieve in the nearly 30 years of its existence.[3]

The Agreement as a Response to Nontariff Trade Barriers

The Agreement addresses nontariff trade barriers (NTBs) to a far greater extent than has any other free trade area. Modest though it is, compared with the total coverage Canadians and Americans should work toward, there is a significant gain on procurement. On standards, the Agreement alters many standards laws that have been used as administrative NTBs to harass agricultural exports, and removes regulations that have been used to stop sales and service people from freely crossing the border. Basically, the Agreement builds on Canada's GATT obligations, confirms them on Canadian-U.S. trade, and provides a framework for going further.

The Agreement also establishes a consultative process with a commitment to develop a new set of countervail and antidumping laws over a five-to-seven-year period. The rejection of a subsidies code at the eleventh hour in the negotiations may have set the tone for a long-term lack of agreement on this issue.

There seems good reason, however, to hope for real gains on antidumping -- particularly the removal, or at least the alleviation of, the infamous "full-allocated-cost" provision, which is a trade barrier pure and simple.

Dispute Settlement

The Agreement brings into existence a complex set of dispute settlement procedures. The details will not be clear until we see the fine print, and the implications will not be clear until the lawyers have debated the fine print for some time. Whatever one's disappointments about what might have been, however, it is hard to see these new procedures as anything other than a major advance over the status quo.

Briefly, the dispute settlement mechanism consists of three major pieces: a legislative watchdog over new legislation, a trade commission to oversee the workings of the Agreement, and a review panel to make binding decisions on disputed antidumping and countervail cases.

The legislative watchdog function offers a number of advantages. For example, once the Agreement takes effect, any new U.S. trade legislation will exclude Canada unless this country is mentioned by name. Prior notification and, if requested, consultation between the two countries must occur before legislation naming Canada is passed. These are important accomplishments. Specific naming ends the "sideswipe" problem, whereby a U.S. measure aimed at a third country inadvertently does serious harm to Canada. Advance notice appears to protect Canada from the commonly used U.S. legislative tactic of adding far-reaching amendments to bills about to be passed that then go through almost unnoticed. The full-allocated-cost antidumping provision was passed in that manner. In future, it is unlikely that such amendments would specifically mention Canada, since the very naming of the United States' free trade partner would attract the attention the tactic is meant to avoid. If Canada were named, the prior consultation clause could then be invoked. Any new U.S. trade legislation also must be consistent with the GATT. This allows Canada to short-circuit the cumbersome GATT review process when legislation that names it appears to conflict with GATT rules.

The second major piece of the dispute settlement mechanism is the Canada-U.S. Trade Commission. This new commission can study disputes and choose to issue a binding arbitration or pursue a consensual type of procedure as in the GATT.

Finally, there is a binational review panel to which each country can appeal antidumping and countervail decisions made under the other country's domestic laws. The panel can make binding determinations according to the laws of the country originally making the decision. An alternative procedure is for the panel to refer the decision back to the national decisionmaking body -- in effect, an order for a retrial. The strict timetable that the new procedures impose guarantees a much faster process than under the GATT and, indeed, secures in Canadian-U.S. disputes a timetable that both countries have urged on the GATT.

For a further assessment of the dispute settlement mechanism, see Box 1. A full evaluation of this imaginative set of institutions must await the final text of the Agreement and the evaluation of legal experts. In the meantime, however, two things seem clear:

- the mechanism represents a substantial improvement over the status quo, and this is something that should not be thrown away lightly;
- to reject the Agreement at this preliminary stage because the mechanism seems not to come up to some prior expectations seems indefensible: why say no before knowing what one is saying no to?

Box 1

Assessment of the Dispute Settlement Mechanism

The value of the Agreement's dispute settlement mechanism cannot be assessed until the fine print has been worked out. In the meantime, however, the following points seem relevant:

- Since the panel uses the procedures of the country whose decision is under appeal, from Canada's point of view the mechanism's value needs to be assessed by those with an intimate knowledge of U.S. trade law. Our soundings of Washington trade lawyers find such people cautiously optimistic that some significant gains have been achieved.
- There is disagreement on what, if any, specific past decisions would have been affected, but many feel that the U.S. countervailing duty case on Canadian softwood lumber would not have gone against Canada.
- Some U.S. trade law experts have argued that the existence of an objective court of appeal will exert a salutary effect on the earlier stages of U.S. countervailing and antidumping investigations. Although this is not easy to judge, it is clear to us that the effect must be a plus rather than a minus. Some feel it could be very significant.

We now go on to evaluate the debate over the Agreement, examining the essence of the debate and the lessons of past experience with trade liberalization in Canada and abroad.

The Great Free Trade Debate

The Great Free Trade Debate continues unabated, and its rhetoric now reaches levels of hyperbole rarely found even in political campaigns. The public is hearing everything from "free trade will mean the beginning of an era of unparalleled national prosperity" to "free trade will mean the end of Canada as a nation." Naturally, such a debate has aroused strong passions and some extreme statements. People on both sides obviously care passionately about Canada's future, and no one needs to apologize for their strong emotions. What is becoming hopelessly confused, however, is passion about ends and passion about means.

Those who let their passionate feelings about the goals of any policy cloud their dispassionate judgments about the appropriate means to achieve their goals are likely to fail in achieving their ultimate objectives. Although Canadians are right to be emotional about being and staying Canadians, we owe it to ourselves to be rational in assessing the best ways to do so.

Several points are needed to put the debate into perspective. Consider the following three facts:

- From an economic point of view, the Agreement is not a new initiative for Canada; instead, it comes close to concluding a policy that was set in train in 1935.
- The Agreement is hardly an untried experiment; rather, from the world's point of view, Canada is a late arrival to this game.
- Among the industrial countries, Canada is unusual in that its industries do not have free access to large markets.

Let us examine these three facts in more detail.

First, free trade with the United States does not represent a dramatic alteration in Canadian economic policy.

With a few twists and turns, Canadian economic policy over the past 50 years has been one of liberalizing trade. Canada signed two trade-liberalizing pacts with the United States in 1935 and 1937, and became a founding member of the GATT in 1947. Since then, Canada has participated in several minor rounds of multilateral tariff cuts and two major ones -- the Kennedy Round and the Tokyo Round. During this time, Canada has removed somewhere between 75 and 90 percent of the trade barriers that existed in 1935. The new Agreement dismantles most of the remaining restrictions on Canada's trade with the United States, its largest trading partner. Therefore, it comes close to completing the program of opening the Canadian economy to foreign trade that began in 1935.

It is difficult to see why removing the last one-quarter of Canada's tariffs would create problems and opportunities that differ from those created by the removal of most of these tariffs over the past 50 years.

What is new in the present Agreement is that it covers only trade with the United States, not trade with all countries. This may well have political and symbolic consequences, which we discuss later, but it is hard to see why the economic consequences should be so radically different from those for all previous trade liberalizations -- all of which were adopted without national debate and carried through without nationally noticed dislocation.

Second, Canada is not getting into some untried new idea.

Just because everyone else is getting into free trade is not a sufficient reason for Canada to do so. It is worth noting, however, that Canada is the only member of the Organisation for Economic Co-operation and Development (OECD), other than Japan, that is not in some form of free trade area or common market association. Furthermore, as Box 2 clearly shows, many less-developed countries are also in regional groupings. These reflect the simple assessment that in today's highly integrated world, large markets really matter. Everyone is trying to make regional groupings work. Some have succeeded more than others, but Canada would be unique in the world if, given the chance, it said no.

Third, Canada is unusual in not having free access to a large market.

Together with Australia and New Zealand, Canada is the only developed country whose industries do not have free access to a market of at least 100 million consumers. Consider the numbers:

- Japan's local market is 120 million people;
- the U.S. market is 240 million people;
- the combined European Community (EC) and EFTA market is 360 million people;
- the Canadian market is 25 million people;
- between them, Australia and New Zealand have 20 million people.

When Canada's exports were mainly primary products -- of which Canada was a major, and in some cases almost the only, supplier -- the world beat a path to Canada's door. Access was not then a great issue. Today, markets are much more competitive. Suppliers of primary products have increased, technological revolutions have introduced many substitutes for these products, and Canada is now a major exporter of manufactured goods over which international competition is fierce. Access is now a key issue.

Box 2

Regional Free Trade and Common Market Groupings

The European Community

Belgium
Denmark
France
Greece
Ireland
Italy
Luxembourg
Netherlands
Portugal
Spain
United Kingdom
West Germany

The Economic Community of West African States

Benin
Burkina Faso
Gambia
Ghana
Guinea
Guinea-Bissau
Ivory Coast
Liberia
Mali
Mauritania
Niger
Nigeria
Senegal
Sierra Leone
Togo

Customs and Economic Union of Central Africa

Cameroon
Gabon
Guinea

U.S.-Mexico Pact
(being negotiated; will likely be modest in scope)

Mexico
United States

The European Free Trade Area

Austria
Finland
Iceland
Norway
Sweden
Switzerland

The Association for the Integration of Latin America

Argentina
Bolivia
Brazil
Chile
Ecuador
Mexico
Paraguay
Peru
Uruguay
Venezuela

The Central American Common Market

Costa Rica
El Salvador
Guatemala
Honduras
Nicaragua

The Lake Chad Basin Commission

Cameroon
Chad
Niger
Nigeria

U.S.-Israel Pact

Israel
United States

The Closer Economic Relationship

Australia
New Zealand

The Caribbean Community

Antigua
Barbados
Belize
Dominica
Grenada
Guyana
Jamaica
Montserrat
St. Kitts-Nevis-Anguilla
St. Lucia
St. Vincent
Trinidad and Tobago

The Andean Pact

Bolivia
Chile
Columbia
Ecuador
Peru
Venezuela

The South African Customs Union

Botswana
Lesotho
South Africe
Swaziland

West African Economic Community

Burkina Faso
Ivory Coast
Mali
Mauritania
Niger
Senegal

A Key Question

Rational debate would be enhanced if opponents would answer the following:

> **Do you oppose the Agreement because Canada did not negotiate a good enough deal, or because you are against any bilateral free trade agreement? If the former, then please state the components of a deal — one which would have had a chance of being accepted — that you would now support.**

It is much easier to assess specific arguments against the Agreement if the person making them is recommending that the deal be rejected because (1) he or she would oppose any bilateral deal or because (2) he or she is dissatisfied with the present deal and feels that a better, and feasible, deal could be negotiated if the present one is rejected. We think the public would find the debate easier to assess if critics were to state their recommended alternatives, and not just make piecemeal criticisms.

Some people are clearly against any bilateral deal with the United States. We are having more trouble, however, identifying those who would reject the present deal because they feel Canada can get a better, and attainable, deal. Assessing their position requires comparing what Canada would lose if it said no to this deal with what it would gain if their better deal were achieved. The bird in the bush, and the probability of catching it, needs to be described if we are to compare it rationally with the bird in hand.

We are serious about this question. As time goes by, we become increasingly concerned about those who are unwilling to present the Canadian public with real choices. By saying that they oppose this deal because Canada could have done better, without clearly specifying the better alternative, they seriously risk calling on Canadians to turn down the bird nesting in the hand for the bird perched in an impenetrable thorn bush.

Those who would reject the Agreement because it includes characteristics that any bilateral deal must have are in the group who would reject any agreement, no matter how much they protest otherwise. The Ontario government, for example, insists that the Agreement entails vast adjustment costs. Since such adjustment costs undoubtedly would apply to any free trade deal, it seems reasonable to include those who make this argument in the group who would oppose any free trade deal.

We urge those who oppose the Agreement on these grounds to identify the outlines of a deal they would be willing to accept. We further urge them to acknowledge that they would then accept the adjustment costs of their preferred deal, costs some are now using as reasons for opposing the present Agreement. Some are trying to have it both ways: saying they oppose this Agreement because they prefer another, while adopting arguments -- such as excessive adjustment costs -- that could be used against any agreement.

Adjustment Costs

The Institute believes that the experience of other countries, as well as Canada's own past experience, in apparently similar situations, should be taken to be relevant, unless reasoned argument persuades us otherwise. The onus of proof lies with those who say the Agreement will unfold in a dramatically different way than have similar pacts elsewhere in the world or than has the past history of Canadian tariff reductions.

Adjustment in Other Countries

Adjustment burdens in the EC, in EFTA, and in the Australia-New Zealand Free Trade Area were all small. Indeed,

in the case of the EC, they were so much smaller than expected that tariff cuts were speeded up rather than slowed down. Why should Canada's case be any different?

Past Adjustment in Canada

Since 1935, Canada has removed most of its tariffs. These cuts have been absorbed virtually without being noticed. Canada is fortunate that the GATT tariff cuts were not publicly scrutinized in the manner of the present debate. If they had been, all the current fears of excessive adjustment costs and the vulnerability of Canadian industries would have been employed in an attempt to block these cuts.

There is no reason why future tariff cuts would be more difficult to absorb than were previous ones, but the Ontario government, in two published papers, has attempted to argue otherwise.

The Ontario papers cannot, however, be considered serious research into the question of the magnitude of the adjustment. The methodology in the first paper is to classify industries into export and import-competing sectors, to count up all the jobs in the latter, and to declare all 281,000 of them to be at risk.[4]

Consider the implications of such an approach if it is to be taken seriously as an anti-trade-liberalizing argument. First, no country would ever have liberalized any of its trade, since all industrial countries have large import-competing sectors. Second, had Ontario's methodology been applied in 1947, most of that province's manufacturing would have been declared at risk, and Canada would have never entered into the GATT. Instead, it would have been stuck with the protected branch-plant economy it then had.

In its second paper,[5] the Ontario government applies the same technique to women. It adds up all the women employed in jobs in import-competing industries and declares all of these jobs to be at risk. Once again, the methodology is badly flawed, for a number of reasons. First, the report gives little more than a classification, and even that does not distinguish between competition from U.S. imports and competition from the rest of the world. Second, it makes no attempt to compare the employment situation in these industries with and without free trade. Third, it makes no allowance for trade diversion. Under free trade, Canadian exports will enter the United States duty free, while competing foreign products will still be tariff burdened. Fourth, it takes no account of any of the economic model simulations that show employment would be higher under free trade than under the status quo. Finally, it ignores the fact that the textile manufacturers, who employ 45 percent of all women in manufacturing, say they will do better with free trade than without it.[6]

In any case, it is the Institute's view that any significant adjustment costs could be handled by a good government assistance package, and we will shortly be calling for a restructuring of adjustment assistance policies.

Will Canada Lose Sovereignty Over Its Social Policies?

This is a key issue in the debate, and an affirmative answer could lead one to oppose any agreement.

A year ago, the issue was whether or not Canada could even risk going to the bargaining table. Opponents said that the U.S. negotiators would ask Canada to give up so much on social policies that it was too risky even to begin to bargain. Supporters maintained that the only way to find out whether these fears were justified was to sit down at the table and try. Canada tried, and the fears have proven unjustified; the Agreement does not even mention Canadian social policies.

So now that the Agreement exists, its opponents have shifted their argument. They now say that Canadian social policies are too costly to be maintained in the face of free trade, implying that liberalized trade will lead to a forced harmonization of social policies. Roy MacLaren, publisher of Canadian Business, puts it this way:

> One cost of doing business is taxation. No Canadian would be so naive as to believe that Washington would amend its tax laws to conform with Canada. So Canadians would then urge Ottawa to make Canadian tax practices conform with those of the United States, even more than they already do. That a comparable tax system (and soon thereafter monetary union) should be seen as an essential element in a successful free-trade area may sound reasonable, but it means in essence that taxation would be decided in Washington, not in Ottawa. That different levels and types of taxation are necessary in two different countries would be ignored.
>
> If Canadian social programs such as medicare, pensions, regional incentives and environmental protection could not then be adequately financed, so much the worse. Those programs should then be changed to conform with U.S. practices.
>
> But that is not all. Since taxation without representation is anathema to all right-thinking democrats, it would presumably occur to some Canadians sooner or later that they should be represented at the place where tax policy was being made, i.e. by seeking to elect representatives to the U.S. Congress.[7]

The issue can be discussed on two levels, theory and practice.

In practice, the evidence does not support the contention. For example, Sweden's social policies are more generous than those of other European countries, yet Sweden trades successfully with the EC without tariff protection. The 72 countries listed in Box 2 have not harmonized their social policies completely, nor have Canadian provinces, nor have U.S. states. Furthermore, since Canada has removed most of its tariff protection since 1935, it already should have been pushed most of the way toward policy harmonization. We can only urge those who believe that completing the process of tariff reduction will suddenly unleash vast harmonization pressures not now felt to explain how this will occur.

To bring theory to bear on this issue, one needs to distinguish between policies that generally raise costs and those that change relative advantages. The latter lead to harmonization pressures. People can migrate in response to high marginal rates of income tax, and this sets up harmonization pressures. However, these pressures need not be given in to fully. The United Kingdom, for example, ignored these pressures, kept its high tax rates, and accepted the loss of actors and pop groups who left for lower tax jurisdictions. Such harmonization pressures exist between any two jurisdictions, and they are stronger the more mobility there is between the two. That they do not force complete harmonization is shown by the evidence of Sweden and scores of other countries.

The relevant issue is the extent to which these pressures will be changed by trading with zero tariffs against trading with the modest tariffs we now have. The apostles of doom need to explain how Canada has been able to maintain the policy independence they seek to preserve while removing the bulk of its tariffs.

On absolute costs -- such as unemployment insurance or universal hospital and medical care paid for through higher taxes -- the theoretical refutation of the harmonization argument is found in the first chapter of any textbook on international trade. It is a

proposition that even the severest critics of trade theory have not tried to upset. Trade depends on comparative, not absolute, advantage. High-cost countries can, and do, trade effectively with low-cost countries. The mechanism that allows this is the exchange rate. If country A finds the money costs of all its goods higher than country B's money costs, adjustment must follow. A's firms and households will sell nothing to B, and will try to buy everything from B. As a result, A's currency will depreciate until A can sell some goods to B, while buying other goods from B. This is no untried theory; it is tested every time one country's currency inflates faster than another's, while its international competitiveness is preserved by a depreciation of its currency.

The application to the Canadian-U.S. case is called the "border tax adjustment theory". It arose over the controversy about the effects of the EC's value-added tax, which was remitted at the border. An unfair export subsidy, said the critics; not so, said one of Canada's greatest economists, the late Harry G. Johnson, in a now classic article that seems to have settled the issue. If a general social policy, such as unemployment insurance, raises costs across the board, it does not destroy competitiveness. Instead, it depreciates the currency. Thus, a flexible exchange rate ensures that, if we want to, Canadians can maintain more generous social policies than does the United States (and the higher taxes that go with them).

Of course, no analysis is final, but knowledge progresses by locating the error in prevailing beliefs. Surely the people who so confidently assert answers to the harmonization issue should feel some modest obligation to tell us where Adam Smith, David Ricardo, John Stewart Mill, Karl Marx (who accepted the theory of comparative advantage), and Harry Johnson all made their errors. Few people who argue that complete harmonization will occur have shown any evidence of being aware of the relevant theory and evidence, let alone of feeling any obligation to refute it.

Harmonization is an issue that concerns us greatly. The Institute tried to advance the debate by holding, and publishing the results of, a symposium on harmonization.[8] We never thought it would be the last intellectual word on the issue, but we did hope that those who care about this issue would feel some obligation either to build on or to dispute this analysis, not to ignore it.

The Canadian Identity

A number of people have argued that the Agreement places at risk the very basis of the Canadian identity. We feel that the Canadian identity is more deeply rooted in our history and geography than these people accept.

The European Community is a vastly tighter association than anything ever contemplated between Canada and the United States. It was born out of the ashes of the Second World War by Europeans who saw it as the first step toward political union. It calls for a great deal of harmonization of social and economic policies. Yet the Danes, the Dutch, and other small partners have maintained their national identities within the tight confines of this community.

The European Free Trade Area was formed by those peripheral countries that wished to avoid the harmonization pressures of the EC, but that also wished for free access to the vast EC market. EFTA is just that: a free trade area without any of the explicit harmonization pressures set up by a common market. Each EFTA country has a free trade agreement with the EC as a whole. Sweden, for example, trades freely with the EC. While managing to maintain its generous social policies, Sweden has also maintained its distinctive national identity.

Ireland and the United Kingdom had a much tighter union than any contemplated Canadian-U.S. scenario. While sharing a common language and culture -- both being occupants of the British Isles -- neither country encountered any of the losses of culture or national identity that some Canadians worry about.

We do not see, even in the wildest stretch of the imagination, that one of the issues Canadians face concerns our giving up our identity. Some prominent politicians have suggested that rejecting the Agreement is the price of being Canadian -- a price we would pay without a moment's hesitation if we thought that were the real choice. Those who hold this view, however, have an obligation to explain what there is about the Agreement that threatens Canada's national identity or political sovereignty. We find it hard to perceive reasoned arguments behind these assertions.

Are There Other Reasons for Rejecting The Agreement?

Questions of loss of sovereignty or national identity aside -- which, if valid, would lead one to reject any agreement -- some people have suggested that, although they would accept free trade with the United States in principle, there are aspects of this particular Agreement that lead them to reject it. These aspects are: the energy section, the provisions on culture, and the requirements for foreign investment review. Again, we call on those who reject the Agreement because of their objections to these aspects to outline an achievable pact that they would accept.

Energy

We must wait for the final text to see what has really been achieved on energy. For example, the supply-sharing arrangement requires further clarification. Supporters in Western Canada and Quebec, however, believe that the Agreement helps to improve the security of access to the U.S. market. Critics argue that Canada has given up an important future right.

The Agreement seems to provide a very soothing balm to the sores created by the National Energy Program. The Agreement gives the West and Quebec improved access to the U.S. market for their oil, gas, and electricity. It provides a guarantee to the energy-producing provinces that the federal government will neither set domestic energy prices lower than those at which energy is exported to the United States nor restrict exports to the United States by more than an agreed formula in the event of a shortage. Canada cannot expect the United States to accept free entry of Canadian energy in times of glut while reserving the right to turn off the tap in times of shortage. If Canada wants to reserve the latter right, it also must deny the West and Quebec the former privilege.

Canada has agreed not to sell energy domestically at a price lower than in the United States, which effectively means not below the competitive price in North American markets. If Ontario and other eastern provinces reject this, they would be saying, in effect, that they are prepared to let the West bear the brunt of the recession caused by low world energy prices but, if world prices recover, they reserve the right to appropriate much of the benefit by forcing the West to sell below world prices. That sounds like heads the East wins and tails the West loses. On the surface, that attitude would seem devisive to national unity.

If the energy part of the Agreement is rejected for good national reasons, the West will probably swallow the pill, however bitter. But if it is rejected for reasons that make no sense in national terms, without even bothering to acknowledge the claims of the West and Quebec for access for their energy exports, serious regional rifts are likely.

It is worth noting that the Agreement does not preclude all sorts of energy policies: exploration and development can be encouraged, the rate of extraction can be controlled, and taxes can be imposed, either at the wellhead or on the consumer. What the Agreement does preclude is the use of these policies as a tool to discriminate in favor of domestically owned, and against foreign-owned, firms.

Culture

Some opponents feared that negotiating with the United States would mean that Canadian cultural policies would be bargained away. Instead, cultural industries have been broadly defined and almost totally exempted. Subsidies and other measures to support culture as narrowly defined were never at risk. Operas, symphony concerts, jazz festivals, and publication subsidies to Canadian authors and Canadian learned journals were never even discussed. Favorable tax treatment for film makers also seem to be still acceptable. What was discussed were the mass cultural industries, such as radio, television, and publishing. But even here, many Canadian measures, such as Bill C-58, escaped completely, and the three negotiated changes are relatively minor.

First, the Agreement removes the modest postal subsidy on high-circulation Canadian magazines. Author Margaret Atwood surely exaggerates when she says, "there go our national magazines." Our soundings lead us to expect no significant effects from this change.

Second, the Agreement ends the use, without payment, of U.S. television signals by Canadian cable television companies. This practice, which some have called international piracy, needed to be rectified. Surely, it is in Canada's self-interest to move toward rational rules to protect intellectual property at the international level. All countries gain when the rule of law is imposed internationally.

Third, Canada has agreed that if it forces divestiture of indirect acquisitions of Canadian subsidiaries in the cultural area, the subsidiary is to be sold at fair market value. Could any fair-minded Canadian disagree? The Agreement allows Canada to retain the right to force such a divestiture. We are not certain that this is a desirable policy, but for what it is worth Canada has retained it.

When all the hype about Canadian culture is considered, precious little was given up. It is hard to believe that the Agreement will affect any significant piece of Canadian culture one way or the other.

Foreign Investment Review

Much of the rhetoric on this issue belongs to the 1960s. Today, Canada is home to many of its own large multinationals. Furthermore, for several years, the annual flow of Canadian direct investment into the United States has exceeded the flow of U.S. direct investment into Canada.[9] As a major foreign investor, Canada has a stake in achieving national treatment of its investments in other countries.

The Agreement preserves both countries' ability to review the large direct acquisitions that become objects of national concern. Considering the great concern in the United States to regularize the climate of foreign investment, and considering Canada's own long-term interest in doing so, this looks like a mutually advantageous concession. Not everyone accepts this, however, and in a later issue of Trade Monitor, we hope to analyze in some detail those policies with respect to foreign investment that are consistent with Canada's GATT obligations and that are precluded by the Agreement.

This is the first issue of the C.D. Howe Institute's new Trade Monitor. The purpose of Trade Monitor is to assess the Canada-U.S. Trade Agreement and to contribute, in an objective, constructive manner, to the current bilateral trade debate. The publication will build on the Institute's extensive research over the past two years on the bilateral trade initiative.

In view of the intense interest in the debate, the Institute intends to publish Trade Monitor on a frequent basis over the next several months. Each issue will focus on a particular element of the debate.

As with all C.D. Howe Institute publications, the views expressed here are those of the author and do not necessarily reflect those of the Institute's members or Board of Directors.

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Almost unnoticed, and before it becomes an issue, the Agreement gives national treatment to Canadian investment in the United States. This safeguards Canada from the United States' doing to us in the 1990s what we did to it in the 1970s. It is a forward-looking achievement, and should not be thrown away lightly.

The Symbolic Battles

The debate is so heated that one can only suppose there must be more fire generating it than we have located so far. Many people feel that the real underlying battle concerns the place of government in the economy.

One major source of the heat is that the great battles over the nationalist policies of the 1970s are being refought today in the context of the Agreement. These are battles over matters of real substance. Many of the nationalist policies were discredited by the end of the 1970s. The Foreign Investment Review Agency was abandoned, both because there was consensus that discouraging foreign capital was not in Canada's self-interest, and because times had changed. Canada is now a major foreign investor and the home base of many Canadian multinationals. In the 1990s, the United States may react to the large amount of foreign ownership in that country. Canada's problem then will be how to preserve its enormous stake in the U.S. shop.

In the 1970s, many countries, including both Canada and the U.S., set the domestic price of energy below the world price. This policy was discredited, because it prevented the necessary adaptation to shortages from the demand and the supply side. The energy crisis ended when countries allowed their domestic prices to rise to the world price, encouraging expansion in output and economization in use. Many of those taking part in the current debate have not accepted the conclusion to which all governments had come by the early 1980s: denying reality by pricing scarce resources below world prices is wasteful and counterproductive.

Throughout the world, social democratic parties are rethinking their policies. Even countries with centrally planned economies, such as the Soviet Union and China, are seeking to give more importance to market determination in

economic decisionmaking. This reaction is based on experience, and on theory. Many European social democrats feel that the worldwide move to privatization and deregulation does not compromise their underlying ends as long as they retain the freedom to maintain egalitarian redistributive policies. In much of the world today, the issue is how to give more scope to the market to decide mainly economic matters, while reserving to the state the right to redistribute and help people relocate themselves.

In Canada, where no social democratic party has yet tasted power at the national level, this issue is seen a little differently. Here, politicians wish to preserve their control over policy levers that their counterparts in other countries have less interest in retaining.

So, many of the participants in the Great Free Trade Debate see themselves fighting a symbolic battle about the direction of change in the Canadian economy. We believe social democratic governments in many other industrial countries would feel that an agreement such as that between Canada and the United States would not constrain their ability to adopt policies they thought sensible -- after all, many of the countries listed in Box 2 were led into their free trade areas and common markets by social democratic governments. But Canadian social democrats, rightly or wrongly, think otherwise.

Is there more to the Great Free Trade Debate than a simple question of how to get a little more national income? Some genuinely see the Canadian identity as at stake, others see the issue as a question of the desired degree of market orientation of the Canadian economy. In our view, neither the Canadian identity nor Canada's political sovereignty is at stake, by any stretch of the imagination. Although many opponents have concerns about the harmonization of Canadian social policies with those in the United States and about adjustment costs under free trade, we believe that, on careful analysis, these concerns can be met satisfactorily.

What many see to be at stake is the issue of whether Canadians want more or less government intervention in the economy. Free trade will constrain government's ability to use trade barriers to shield weak industries from international competition -- a result that we believe will lead eventually to stronger, more competitive industries. It will not, however, constrain the ability of Canadian governments to follow most progressive social and economic policies. No doubt, 20 years from now, even with a free trade agreement, Canadians will still be arguing about the degree of government involvement in Canadian life. In that respect, the Great Free Trade Debate is about a modest number of specific changes in Canada's economic policies. Many people, however, see the debate as involving a symbolic decision that may point the direction for the evolution of the general relationship between the citizen and the State in the years to come.

Notes

1. Richard G. Lipsey and Murray G. Smith, Taking the Initiative: Canada's Trade Options in a Turbulent World, Observation 27 (Toronto: C.D. Howe Institute, 1985), p. 183.

2. So when Roy MacLaren says that there is nothing about access in the Agreement, he misses the main point of the Agreement ("Sovereignty being traded for U.S. markets," Globe and Mail [Toronto], November 10, 1987, p. A7).

3. For a detailed review of the EFTA experience, see Victoria Curzon Price, Free Trade Areas, the European Experience: What Lessons for Canadian-U.S. Trade Liberalization?, Observation 31 (Toronto: C.D. Howe Institute, 1987).

4. Ontario, Ministry of Industry, Trade and Technology, Assessment of Direct Employment Effects of Freer Trade for Ontario's Manufacturing Industries (background paper for the Annual First Ministers' Conference, Halifax, November 28-29, 1985), p. i.

5. Ontario, Women's Directorate, The Free Trade Agreement and Women (Toronto, November 1987).

6. Canadian Textiles Institute, Submission to Ontario Public Hearings on Free Trade, October 21, 1987.

7. MacLaren, p. A7.

8. C.D. Howe Institute, Policy Harmonization: The Effects of a Canadian-American Free Trade Area (Toronto, 1986).

9. See Alan M. Rugman, Outward Bound: Canadian Direct Investment in the United States, (Toronto; Washington, D.C.: Canadian-American Committee, 1987).

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